Internal Revenue Service

memorandum

CC:TL-N-2556-91
Br2:LSMannix

date: MAR 25 1991

to: District Counsel, Los Angeles W:LA

from: Assistant Chief Counsel (Tax Litigation) CC:TL

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subject: [redacted] Tax Litigation Advice

This responds to your request for advise, dated December 27, 1990. It is our understanding that this case is calendared for trial in [redacted].

ISSUE

whether ESOP contributions paid by original members of the [redacted] affiliated group on behalf of new members of the group during the period in which the group filed consolidated returns may be carried back by the paying members to a year in which the new members were not part of the group.

RECOMMENDATION

That portion of the net operating loss carryback attributable to the ESOP contribution paid by original members of the [redacted] group of behalf of the new members cannot be carried back to earlier years of the [redacted] group. Therefore, we recommend litigating this issue if the taxpayers do not substantially concede. Futhermore, we recommend stating to the court that LTR 84-22-142 (May 5, 1984), upon which the taxpayers are relying, is an incorrect statement of the law and is not the Chief Counsel's or the Service's position.

FACTS

According to your request, the facts are as follows. [redacted] is the common parent of an affiliated group of corporations that provide [redacted] services to customers worldwide. In [redacted] acquired [redacted]% of the stock of [redacted]. [redacted] was the common parent of an affiliated group of [redacted] companies based in [redacted]. The [redacted] group joined with the [redacted] group in filing a consolidated return for [redacted].

The employees of the [redacted] group elected to transfer their interests in the pension plan at [redacted] to the ESOP at [redacted]. For the year [redacted], the [redacted] group, which now

included the [redacted] group, made a contribution to the ESOP equal to the maximum amount deductible under section 404. The ESOP contribution was allocated among the members of the group on the basis of the compensation paid by each member to its employees. $[redacted] was allocated to corporations that were formerly part of the old [redacted] group.

However, the former members of the old [redacted] group did not have the financial resources to pay their portion of the ESOP contribution and the payments were made by corporations that were originally part of the [redacted] group. The payments were recorded on the books of the payor and payee corporations as accounts receivables and payables. It appears that the amounts will never be repaid.

The [redacted] group suffered a net operating loss for [redacted] which it now seeks to carryback to its [redacted] taxable year. Part of this loss is attributable to that portion of the ESOP contribution paid by original members of the group of behalf of members that were formerly part of the old [redacted] group. The taxpayers claim that the corporations that actually made the payments are entitled to the deduction under section 404 and, therefore, that those corporations are allowed to carryback that portion of the net operating loss to their earlier taxable years.

The Commissioner disallowed the above described portion of the carryback on the grounds that the only corporations that can claim the deductions under section 404 are the former members of the old [redacted] group on whose behalf the payments were made. Because the former members of the old [redacted] group were not members of the [redacted] group for the earlier years, the Commissioner asserted that, under Treas. Reg. § 1.1502-79, the above described portion of the net operating loss cannot be carryback to earlier years of the [redacted] group.

DISCUSSION

The taxpayers rely on LTR 84-22-142 (May 5, 1984) and GCM 39,208 for the proposition that the members who actually made the payments on behalf of other members of the group are entitled to deductions under section 404. GCM 39,208 held that payments made by a corporation to a defined benefit pension plan and a money purchase pension plan on behalf of another, recently acquired, member of the same controlled group could not be deducted by the corporation who actually made the payments because the employees of the new member did not adopt the same plans as the employees of the corporation who made the payments. LTR 84-22-142 took this holding once step further and held that payments made by a corporation to a defined pension plan and a money purchase pension plan on behalf of another member of the same controlled group, all of whose employees adopted the same plan, was

deductible under section 404 by the corporation who actually made the payments.

We have discussed LTR 84-22-142, GCM 39,208 and this case with the appropriate divisions of the National Office and they have formally stated to us that the letter ruling is an incorrect statement of the law and does not represent the Chief Counsel's or the Service's position. They have stated that there is no authority for the proposition that a corporation who makes a payment to an ESOP, defined benefits plan or money purchase plan on behalf of another corporation can claim a deduction for the payment under section 404, regardless of whether the corporations are part of the same controlled or affiliated group. At this time, however, the National Office does not intend to revoke the letter ruling or the GCM. Therefore, we recommend stating to the court that LTR 84-22-142 is an incorrect statement of the law and is not the Chief Counsel's or the Service's position.

It should also be noted that the holding of the GCM is correct, although its rationale is misleading. In the GCM, even if the employees of the corporation on whose behalf the payments had been made had elected to be part of the plan used by the employees of the corporations who actually made the payments, the payments would still not have been deductible by the corporations who actually made the payments.

It is well settled that obligations or expenses of one corporation paid by a second corporation, both of which are part of the same controlled or affiliated group, are only deductible by the first corporation on whose behalf the payment is made. If the relationship between the first corporation and the second is that of parent and subsidiary, the payment is treated as a dividend from the second corporation to the first. If the relationship between the first corporation and the second is that of subsidiary and parent, the payment is treated as a capital contribution. If the relationship between the first corporation and the second is that of brother and sister, the payment is treated as a dividend from the second corporation to the common parent of both and then as a capital contribution by the parent to the first corporation. See Interstate Transit Lines v. Commissioner, 319 U.S. 590 (1943); Deputy v. Dupont, 308 U.S. 488 (1940). See also Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders, ¶ 15.04 4 (and cases cited therein).

Reg. § 1.1502-79(a)(1) states that if a net operating loss generated in a year in which an affiliated group files a consolidated return can be carried, under section 172, to a year in which one or more members of the group were (or are) not members of the same group, the loss must be apportioned among the members of the group and that portion of the loss attributable to

a member that is not part of the same group in the year to which the loss is carried cannot be included in the consolidated return of the group in that year. Reg. § 1.1502(a)(3) outlines the method of calculating the amount of the loss to be apportioned to the various members of the group. In determining the amount of the group's loss that is apportioned to a particular member, that member's "separate net operating loss" must be calculated under Treas. Reg. § 1.1502-12. The "separate net operating loss" of the member would include any section 404 deduction to which it is entitled. Reg. § 1.1502-12. Thus, pursuant to the calculation in Reg. § 1.1502-79(a)(3), a section 404 deduction taken by a member would be apportioned to that member and, under Reg. § 1.1502-79(a)(1), could not be carried to a year in which that member was not a member of the same group.

Applying the above law to the facts of this case leads to the conclusion that that portion of the net operating loss attributable to the ESOP contribution paid by original members of the [redacted] group of behalf of members that were formerly part of the old [redacted] group cannot be carried back to earlier years of the [redacted] group. The only corporations that can claim the deduction under section 404 for the above described payments are the former members of the old [redacted] group on whose behalf the payments were made. Under Reg. § 1.1502-79(a)(3) the "separate net operating loss" of the former members of the old [redacted] group on whose behalf the above described payments were made would include the section 404 deduction. The section 404 deduction would then be apportioned to such members under the calculations in Reg. § 1.1502-79(a)(3) and, under Reg. § 1.1502-79(a)(1), that portion of the loss could not be carried back to the earlier years of the [redacted] group because the former members of the old [redacted] group were not members of the [redacted] group during those years.

If you have any questions, please contact Lawrence S. Mannix at FTS 566-3470.

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